



University of Tennessee, Knoxville
**Trace: Tennessee Research and Creative
Exchange**

Accounting and Information Management
Publications and Other Works

Accounting and Information Management

January 2006

Audit Committee Financial Experts: A Closer Examination Using Firm Designations


Joseph V. Carcello

University of Tennessee, Knoxville, jcarcell@utk.edu

CW Hollingsworth

Terry L. Neal

Follow this and additional works at: http://trace.tennessee.edu/utk_accopubs

 Part of the [Accounting Commons](#), [Business Administration, Management, and Operations Commons](#), [Business Law, Public Responsibility, and Ethics Commons](#), and the [Corporate Finance Commons](#)

Recommended Citation

Carcello, Joseph V.; Hollingsworth, CW; and Neal, Terry L., "Audit Committee Financial Experts: A Closer Examination Using Firm Designations" (2006). *Accounting and Information Management Publications and Other Works*.
http://trace.tennessee.edu/utk_accopubs/1

This Article is brought to you for free and open access by the Accounting and Information Management at Trace: Tennessee Research and Creative Exchange. It has been accepted for inclusion in Accounting and Information Management Publications and Other Works by an authorized administrator of Trace: Tennessee Research and Creative Exchange. For more information, please contact trace@utk.edu.

Audit Committee Financial Experts: A Closer Examination Using Firm Designations

Joseph V. Carcello, Carl W. Hollingsworth, and Terry L. Neal

SYNOPSIS: The Sarbanes-Oxley Act (SOX) requires the disclosure of whether the audit committee has a financial expert. We examine disclosures related to audit committee financial experts (ACFEs) in the first year that this disclosure requirement is in effect. We find that virtually all companies disclose whether an ACFE is on the audit committee, although the transparency of the disclosure regarding the ACFE's background is limited. We also find that most ACFEs do not have a background in accounting or finance, although there are notable differences between stock exchanges on this dimension. In addition, we find that companies designate ACFEs who would not have been identified using extant research methods, and companies fail to voluntarily designate many individuals who appear to qualify as an ACFE, particularly if another audit committee member is already designated as an ACFE. Thus, some companies appear to be extremely conservative in designating directors as ACFEs, possibly due to concerns about the legal liability faced by designated ACFEs. Finally, we identify certain company characteristics that are associated with the designation or type of financial expert on the audit committee.

INTRODUCTION

The Sarbanes-Oxley Act (SOX) (U.S. House of Representatives 2002) required the Securities and Exchange Commission (SEC) to adopt rules requiring each public company to disclose whether its audit committee includes at least one member who is a financial expert. The SEC's final rule (SEC 2003) requires companies to disclose: (1) whether at least one financial expert sits on the audit committee and, if so, the individual's name and whether (s)he is independent, and (2) if a financial expert does not sit on the audit committee, the reasons why. The SEC argues that having at least one financial expert on the audit committee should improve the quality of information available to investors. Consistent with the SEC's supposition, recent empirical work finds that audit committee financial expertise is associated with less earnings management, fewer restatements, and a

Joseph V. Carcello is a Professor, Carl W. Hollingsworth is a Doctoral Candidate, and Terry L. Neal is an Associate Professor, all at the University of Tennessee.

We thank the research fellows of the University of Tennessee's Corporate Governance Center, especially Dana Hermanson, Ron Shrieves, and Tracie Woidtke, and workshop participants at the University of Connecticut for their helpful comments on earlier versions of this paper. We also thank Bob Lipe (editor) and two anonymous reviewers for their helpful comments.

Submitted: July 2005

Accepted: July 2006

Corresponding author: Terry L. Neal
Email: tneal3@utk.edu

lower cost of debt (e.g., Abbott et al. 2004; Agrawal and Chadha 2005; Anderson et al. 2004; Bédard et al. 2004). In addition, other studies find a significant positive stock price reaction when a financial expert is added to the audit committee (Davidson et al. 2004; DeFond et al. 2005).

However, since the SEC's final rule on financial expert disclosure was not effective until annual reports were filed for fiscal years ending on or after July 15, 2003, prior examinations of financial expertise identify directors as financial experts based on the information in the biographical data from the proxy. This biographical data is typically limited in scope and does not always provide a clear indication as to each director's level of financial experience. Thus, our paper is among the first papers to examine disclosure behavior after the issuance of the SEC's final rule, which allows us to classify financial experts based on the company's disclosed designations.

In this paper, we make the following contributions. First, we provide insights on various aspects of the newly required disclosures regarding financial experts, such as (1) the transparency and quality of these disclosures, (2) variations in the way the SEC rule is interpreted across firms, and (3) the frequency of firms that do not designate a financial expert (including some insights as to what the audit committees for these firms look like). Second, we provide descriptive information as to the employment history of individuals designated as an audit committee financial expert (ACFE). Most studies that find salutary benefits associated with the presence of an ACFE use a narrow definition of financial expertise—typically defining financial expertise based on the accounting or finance background of the audit committee member. Although the SEC originally proposed to define financial expertise in this manner, the Commission's final rule defines expertise more broadly (e.g., many CEOs and other senior operating executives would qualify as financial experts under the SEC's expanded definition). Given that the benefits of financial expertise may relate to only certain types of expertise, assessing the backgrounds of ACFEs is important. We also compare our results to those reported in prior research (e.g., DeFond et al. 2005) to highlight the differences in using company designations rather than biographical data to identify ACFEs. Third, we document differences in financial expertise for companies that are listed on different stock exchanges. Finally, we use regressions to identify certain company characteristics that are associated with the designation and type of financial experts on the audit committee.

Using a sample drawn from the first group of companies to file after the new disclosure rule became effective, we examine the financial expert disclosure of 400 companies—the 100 largest domestic, public *Fortune* 500 companies; and 300 companies drawn at random, 100 each from the NYSE, Nasdaq National Market System (NMS), and Nasdaq National Dealer Quotation (NDQ).

First, we find that although compliance with the SEC's financial expert disclosure rule is high (only 2 percent of companies were not in compliance), the quality of the disclosures is often lacking (only 5 percent provide a significant discussion concerning the financial expert). Further, the boards' criteria for determining whether an individual qualifies as a financial expert generally lack transparency because the disclosures typically use boilerplate language. Although disclosing the board's criteria for deciding whether an individual qualified as a financial expert is not required by the SEC's final rule, the almost complete absence of this disclosure from securities filings is problematic because users cannot determine how a particular individual's background results in "financial expertise" in a number of instances.

Second, we find that ACFEs designated by the company typically do not possess an accounting or finance background (the very backgrounds associated with positive financial

reporting outcomes in the extant literature). The modal background of ACFEs is serving as a CEO. Many companies' failure to select an ACFE with an accounting or finance background may reduce (or eliminate) the financial reporting benefits expected from this provision of SOX. Furthermore, this finding, combined with the general lack of disclosure of directors' qualifications for being an ACFE, raises concern as to how prior research has classified financial experts. We find significant differences in the coding of financial experts using the DeFond et al. (2005) (hereafter, DeFond et al.) approach as compared to using the company designations in the proxy. For example, 86 financial experts designated by the companies in our sample would not have been identified as ACFEs by DeFond et al., and more than 500 audit committee members would be classified as an ACFE by DeFond et al. but are not so designated by the company.

Finally, our regression analyses find that the designation of an ACFE is positively associated with firm size, being in a litigious industry, and having an active audit committee. For those companies that designate an ACFE, we find a positive association between that expert having an accounting or finance background and the subsequent issuance of common stock or debt securities and the level of institutional ownership. We find a negative association between the designation of an ACFE with an accounting or finance background and having a Big 4 audit firm.

The rest of the paper is organized as follows. The next section presents a brief discussion of the SEC's rule making related to financial expert disclosures. Our sample selection process follows. We then discuss some of the insights from the newly required disclosures followed by an examination of the backgrounds of the ACFEs. We continue with regression analyses of company characteristics that are associated with the designation and type of ACFEs. The conclusion summarizes our findings, discusses the paper's limitations, and identifies possible directions for future research.

REGULATORY BACKGROUND

Section 407 of SOX (U.S. House of Representatives 2002) required the SEC to issue a rule requiring public companies to disclose whether their audit committee has at least one financial expert, and if not, the reasons why. The SEC received more than 200 comment letters, many of which criticized its proposed rule (SEC 2003). Smaller companies argued that they would find it difficult to attract a financial expert to sit on their audit committees (SEC 2003). As such, we expect that smaller companies are more likely to disclose that their audit committee has no financial expert (an acceptable option under the SEC's final rule).

A second form of opposition related to directors' legal liability. Commenters expressed concern that *designating* a director as an ACFE, even if not publicly disclosed, might increase his/her exposure to legal liability, and *identifying* the ACFE in the financial reports would exacerbate this problem (SEC 2003). This concern persists despite the SEC's inclusion of a safe harbor in the final rule that states that being designated as an ACFE does not change an individual director's duties, responsibilities, or legal liability from what would have been if the individual was not designated as a financial expert. Therefore, some companies may choose not to designate any audit committee members as ACFEs, even if they qualify, so as to not expose committee members to additional liability. However, the fear

of added liability did not stop some of our sample companies from voluntarily identifying more than one financial expert on the audit committee.¹

Even if a company designates an ACFE, the threat of shareholder litigation may reduce the robustness of disclosures about their expert(s) (Healy and Palepu 2001). In spite of the SEC's concern about uninformative disclosures in filings (SEC 2002a), we expect companies to provide limited support for their decisions to categorize a director as an ACFE for at least two reasons. First, if the designated ACFE has a substantive accounting or finance background, then providing detailed disclosure on the individual's background may increase that individual director's liability exposure because the ACFE may be held to a higher standard of performance. For example, a recent Delaware Chancery Court decision states that directors with special expertise can be held to a higher legal standard of performance (Scannell 2004). Second, if a company discloses that the designated ACFE's accounting and finance expertise is modest, then the company's choice of ACFE may attract unwanted attention by regulators, analysts, or the financial press.

Another issue concerns the definition of an ACFE. The SEC's original proposal (SEC 2002b) would have required a financial expert to have: (1) an understanding of GAAP, (2) experience applying GAAP in the area of estimates, accruals, and reserves, (3) *experience preparing or auditing financial statements*,² (4) experience with internal controls, and (5) an understanding of audit committee functions. Critics of the rule opined that only accountants would meet the definition, and that such financial luminaries as Alan Greenspan and Warren Buffet would not qualify as an ACFE (e.g., Colvin 2002). The final rule modified criterion 3 from above to require that the expert have, "experience preparing, auditing, analyzing, or evaluating financial statements ... or experience *actively supervising* one or more persons engaged in such activities" (emphasis added) (SEC 2003). Given the expanded definition of a financial expert in the SEC's final rule and the corporate community's resistance to requiring a financial expert to have an accounting/finance background, we expect a significant percentage of designated financial experts to have a general management background rather than an accounting/finance background.

In addition to the relatively new disclosure requirements regarding financial expertise, listing standards at the major stock exchanges also address this issue. The listing standards are not uniform across exchanges, and they permit some flexibility in allowing a board to determine the composition of their audit committee. For example, the NYSE requires each audit committee to include at least one member who has accounting or related financial management experience, while the NASDAQ extends its consideration of financial expertise to include "other comparable experience or background," which results in the financial sophistication of the director. The Nasdaq listing standards specifically mention having been a chief executive officer or other senior officer with financial oversight responsibilities as an example of ways to obtain financial sophistication (Bostelman 2004). Throughout the paper, we will discuss instances in which our ACFE results differ by stock exchange.

SAMPLE

To examine companies' financial expert disclosures, we select samples of 100 companies from four different groups—*Fortune* 500 companies, and companies traded on the NYSE, Nasdaq's NMS, and Nasdaq's NDQ. For the *Fortune* 500 companies, we identify

¹ For convenience, we use the word "designation" throughout the paper to denote whenever a company publicly claims to have one or more ACFEs. In all but two instances, the individual designated as an ACFE is also specifically identified by name.

² We italicize this requirement to denote that this requirement changed between the SEC's proposed rule and its final rule.

these companies using *Fortune's* 2003 listing and then exclude nonpublic companies, foreign companies, and companies whose fiscal year ended between January 1 and July 14, 2003 (the SEC's financial expert disclosure rule became effective for reporting periods ending on or after July 15, 2003). We then select the largest 100 companies that are not excluded.³ For companies traded on the three exchanges, we select a random sample from each of the exchanges of 100 domestic companies with fiscal year-ends between July 15, 2003 and December 31, 2003 using Compact D/SEC.

INSIGHTS GLEANED FROM NEWLY REQUIRED DISCLOSURES

Compliance with ACFE Disclosure Rule

Table 1 provides an overview of the ACFE status for our sample of 400 companies. For 285 companies, the designated ACFE was on the audit committee before the passage of SOX; 250 of these companies did not add any new ACFEs in 2003 or 2004 and 35 of these companies added an additional ACFE in the last two years.⁴ The only ACFE designated was added to the audit committee in 2003 or 2004 for 81 companies.⁵ Twenty-five companies disclose a lack of an ACFE,⁶ seven companies fail to make the required disclosure, and two companies state that they have an ACFE without naming the individual director. These results suggest that 391 (98 percent) of the companies in our sample made the required financial expert disclosure, and that almost 30 percent of our sample companies increased the number of experts on their audit committees since the passage of SOX.

TABLE 1
Summary of Companies

Had an existing ACFE, but did not add an additional ACFE in 2003 or 2004	250
Added an additional ACFE in 2003 or 2004	35
Added the only ACFE in 2003 or 2004	81
Disclose they do not have an ACFE	25
Make no disclosure	7
Disclose they have an ACFE but do not tell how many or name them	2
Total companies	<u>400</u>

³ Our 100 *Fortune* companies are selected from the first 139 *Fortune* 500 companies. None of the *Fortune* companies are included in the other three samples.

⁴ SOX was passed in the summer of 2002; thus we presume financial experts added to the audit committee in 2003 or 2004 is in response to SOX and the SEC's rulemaking that require the disclosure of whether a financial expert sits on the audit committee. Although a financial expert could have been added to the audit committee in 2002 in response to SOX, most proxy statements were filed in the spring, well in advance of the passage of SOX.

⁵ To make this determination, we examine the board tenure of each disclosed ACFE. We classify a company as designating their only ACFE(s) in 2003 or 2004 if they disclose having at least one ACFE and none of the disclosed ACFE(s) have a tenure on the board of more than one year. Similarly, we classify a company as having an ACFE prior to SOX if they designate a director as a financial expert in 2003 and that director's board tenure indicates (s)he was on the board prior to SOX. We recognize that a company whose only designated ACFE was added to the board in 2003 or 2004 could have had a *non-designated* ACFE on the audit committee before SOX. Either an existing audit committee member could possess financial expertise but not be designated as an ACFE, or the designated ACFE who joined the board in 2003 or 2004 could have replaced another board member who would have qualified as an ACFE.

⁶ All of the companies in our sample trade on a stock exchange (NYSE or Nasdaq) that requires at least one audit committee member to possess financial expertise or sophistication. The 25 companies that fail to designate an ACFE may still be in compliance with exchange-listing standards because the exchanges' definition of expertise/sophistication is broader than the SEC's definition of an ACFE.

Panel A of Table 2 provides some basic descriptive statistics on the companies included in our sample. Mean sales are highest for the *Fortune* companies (\$36,258 million) and lowest for the NMS and NDQ companies (\$311 million and \$51 million, respectively). Panel B provides descriptive statistics on the number of audit committee members and the number of ACFEs. The mean number of audit committee members for the entire sample is 3.81; on average, 1.47 of them are ACFEs. The means of the subsamples reveal that numbers of members and experts increase with company size.

Transparency and Quality of Disclosures

Although the SEC specifies certain disclosures that companies must make with respect to the financial expertise of their audit committees, the companies have considerable discretion as to the transparency of these disclosures. For example, some companies may only disclose a very limited amount of information, while others may provide detailed explanations about the financial expertise of their audit committee. We assess the transparency of the disclosures by our sample of companies based on factors such as where the disclosures are made, how many experts are named, and how detailed the disclosures are.

TABLE 2
Descriptive Statistics
Company and Audit Committee Characteristics

	Total (n = 400)	Fortune (n = 100)	NYSE (n = 100)	NMS (n = 100)	NDQ (n = 100)
Panel A: Company Characteristics^a					
Total Sales (in \$millions)					
Mean	9,732.47	36,257.60	2,310.55	311.16	50.57
Median	462.28	24,864.00	1,361.94	85.36	17.91
Minimum	0.00	3,935.40	93.63	0.30	0.00
Maximum	213,199.00	213,199.00	15,867.00	7,722.00	869.00
Total Assets (in \$millions)					
Mean	34,628.27	131,032.20	6,363.60	935.47	181.84
Median	840.05	37,073.00	1,921.61	288.18	30.66
Minimum	2.29	5,474.16	130.45	13.85	2.29
Maximum	1,264,032.00	1,264,032.00	87,534.00	10,311.62	2,196.30
Panel B: Audit Committee Characteristics^b					
Number of Audit Committee Members					
Mean	3.81	4.62	3.84	3.38	3.39
Median	3	4	4	3	3
Minimum	2	3	3	2	2
Maximum	8	8	7	8	6
Number of Financial Experts					
Mean	1.47	2.20	1.57	1.09	1.02
Median	1	1	1	1	1
Minimum	0	1	0	0	0
Maximum	6	6	6	3	3

^a Total Sales and Assets are obtained from Compustat.

^b Data for the number of audit committee members and financial experts are obtained from the 2004 proxy statement or the fiscal 2003 Form 10-K when the proxy statement does not disclose the information.

Location of Disclosures

Companies can choose whether to include the disclosures in their 10-K, proxy statement, or both. Figure 1 provides information on the percentage of companies in our sample that make their disclosure in each of these filings. Most companies make this disclosure available only in their proxy statement (80 percent), while some do so only in their 10-K (12 percent). A smaller portion of our sample companies (6 percent) actually makes the disclosure in both their proxy statement and 10-K. These results suggest that very few companies are going beyond the minimum requirements with respect to where they make their disclosures regarding audit committee financial expertise.

Number of Experts Named

Companies are permitted, but are not required, to disclose whether more than one financial expert sits on the audit committee. As shown in Figure 2, approximately 28 percent of the sample companies designate more than one ACFE. Almost all of these additional financial experts are named. Disclosure of multiple financial experts is more common among larger companies; 50 percent of *Fortune* companies and 34 percent of NYSE companies reveal they have more than one financial expert. Only 13–14 percent of Nasdaq companies disclose that they have multiple experts.^{7,8}

We posit that some companies may name multiple experts, possibly including the entire audit committee, as a means of diffusing the responsibility and potential liability that may fall on one person if only a single financial expert is named. Alternatively, some companies may believe that having more than one financial expert contributes to audit committee effectiveness. As illustrated in Figure 2, approximately 9 percent of the companies assert that every audit committee member is a financial expert. Very large companies are more likely to claim that the entire audit committee is comprised of financial experts; 16 percent of *Fortune* companies disclose that all committee members are financial experts, and this proportion is significantly greater than the 4 to 5 percent of Nasdaq companies that make comparable disclosures.

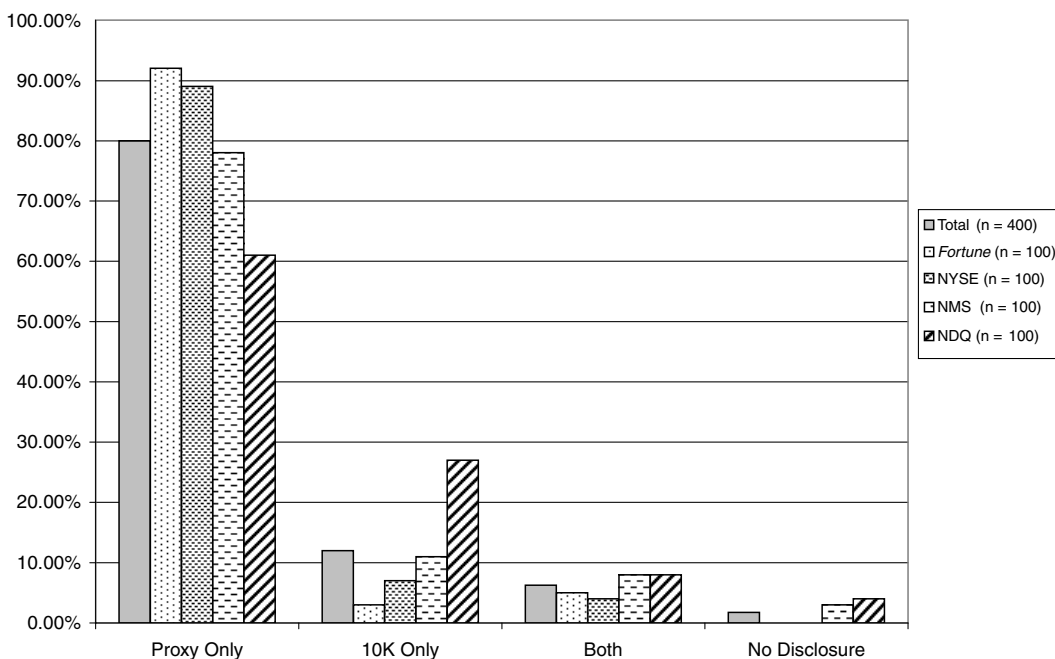
Level of Detail in Disclosures

Companies also have some discretion as to the level of detail they include in explaining the company's decision to not have an ACFE, or in their explanation of why an individual director qualifies as an ACFE. As shown in Figure 2, approximately 6 percent of our companies (five NYSE, eight NMS, and 12 NDQ companies) state they do not have an ACFE. A few examples of the reasons given for not having a financial expert are provided in Panel A of Exhibit 1. The most common disclosure simply points out that the company does not have an ACFE, and that the company's audit committee members are selected based on their ability to oversee the accounting and financial reporting processes of the company. As DeFond and Francis (2005, 21) state, "the SEC is willing to consider good reasons why some firms should not have experts." In our view, simply stating that the company does not have a financial expert and explaining the company's reasons for selecting the existing audit committee members does *not* comply with the SEC's requirement

⁷ *Fortune* companies are more likely to designate multiple ACFEs than are NYSE companies ($p < 0.05$), NMS companies ($p < 0.01$), and NDQ companies ($p < 0.01$); NYSE companies are more likely to designate multiple ACFEs than are NMS and NDQ companies ($p < 0.01$).

⁸ All tests for differences in means throughout the paper are based on t-statistics (Z-statistics) for continuous variables (proportions). The tests assess if the average value of a variable for a particular group is sufficiently different from the average value for the comparison group to conclude that the cross-group difference is unlikely to occur by chance.

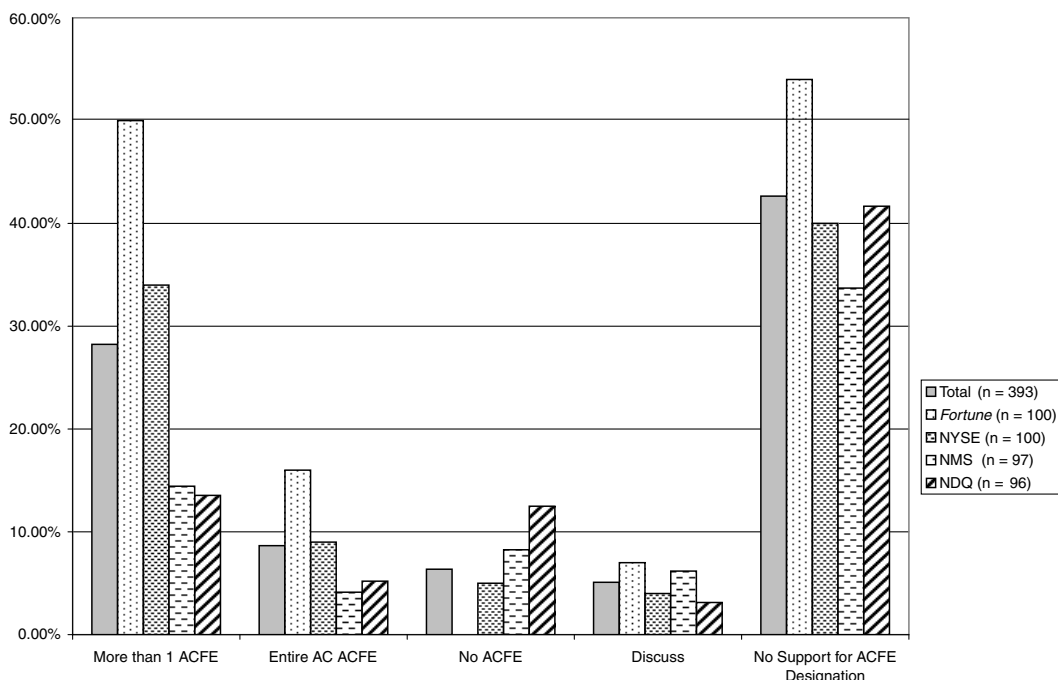
FIGURE 1
Location of ACFE Disclosures



to explain why a financial expert does not sit on the audit committee. Disclosing that the company does not have a financial expert, which is a common disclosure for those companies without an ACFE, does not explain *why* the company believes that an ACFE is not needed.

As shown in Panel A of Exhibit 1, Protective Life (a NYSE firm) includes a very detailed discussion of their reasons for not having an ACFE. This company reports that its audit committee meets the independence and financial expertise requirements of the NYSE (which are more lenient than the SEC's ACFE definition), but that the company does not believe that any of its audit committee members qualify as an ACFE, particularly considering the commentary that accompanied the SEC's adopting release. Although the composition of this company's audit committee includes three current CEOs, individuals who have significant academic business training, and individuals who have experience working in banking, investments, and mergers and acquisitions, we are left to conclude that none of these individuals have experience in preparing, auditing, analyzing, or evaluating financial statements or experience in actively supervising one or more persons engaged in such activities. As we discuss during our examination of the backgrounds of ACFEs in the next section, this company's conservative interpretation of the SEC's rule—which we believe is consistent with the Commission's intent in its original rule proposal—does not appear to

FIGURE 2
Frequencies of Designation and Disclosure of ACFEs by Sample Companies^a



^a Variable Definitions:

More than 1 ACFE = the percentage of companies designating more than one audit committee financial expert;

Entire AC ACFE = the percentage of companies designating the entire audit committee of the company as audit committee financial experts;

No ACFE = the percentage of companies disclosing not having an audit committee financial expert;

Discuss = the percentage of filings containing significant discussion of the audit committee financial expert; and

No Support for ACFE Designation = the percentage of companies for which we cannot determine from the disclosure in the proxy or 10-K that any of the disclosed financial experts meet the definition of an independent audit committee financial expert. Unlike all the other categories, the percentage reported is based on only those companies disclosing that they have an audit committee financial expert (n = 368 Total, n = 100 *Fortune*, n = 95 NYSE, n = 89 NMS, and n = 84 NMS).

be the norm among public companies.⁹ Evidence reported below suggests that companies routinely consider individuals with senior management experience to qualify as an ACFE, regardless of the ambiguity of the audit committee member's background in preparing,

⁹ In fact, Protective Life may be interpreting the SEC's final rule too conservatively. Protective Life states that a financial expert does not sit on its audit committee, but one of its audit committee members is an investment banker. The SEC's final rule indicates that audit committee members with a background in investment banking or venture capital would appear to qualify as an ACFE (SEC 2003). Protective Life may not have designated any of its audit committee members as ACFEs so as to not expose these individuals to additional litigation risk.

EXHIBIT 1
Examples of ACFE Disclosures

Panel A: Reasons for Not Having an Audit Committee Financial Expert**Most Common Disclosure of Reason for Not Having an ACFE (similar disclosures appear 8 times)**

The Board of Directors of the Company has determined that the Company does not have an “audit committee financial expert,” as defined in 17 CFR Section 228.401(e)(2), serving on its Audit Committee. The Board has selected Audit Committee members based on the Board’s determination that they are qualified to oversee the accounting and financial reporting processes of the Company and audits of the Company’s financial statements.

Detailed Reason for Not Having an ACFE***Protective Life Corp.***

The members of the Board have determined that each member of the Audit Committee meets the independence and financial expertise requirements of the New York Stock Exchange. The Board does not feel that, under conservative interpretations of Items 401(h) of Regulation S-K (including the commentary that accompanied the adopting release), the members of the Audit Committee meet the definition of an audit committee financial expert. The Board nevertheless feels that ample financial literacy, experience, and expertise is possessed by the current members of the Audit Committee to perform the functions of the Committee and to provide appropriate oversight, scrutiny, and guidance. For example, Mr. French has an M.B.A. from Harvard Business School; he is currently Chairman and CEO of Dunn Investment Company, the parent of a group of companies and an investor in equity securities. Mr. Cooper has a B.S. in Finance from the University of Notre Dame; he is currently Chairman and CEO of Commonwealth National Bank, a privately held national bank. Mr. Day has an M.B.A. in Finance from the University of Pennsylvania; he previously served as the head of Goldman, Sachs & Co.’s mergers and acquisitions group and currently is chairman of the Executive Committee of Jemison Investment Company, Inc., a privately held investment company. Mr. James has an M.B.A. from The University of Alabama and a law degree from the University of Virginia; he is currently the Chairman and CEO of Vulcan Materials Company, a publicly traded company listed on the New York Stock Exchange. In addition, if any Committee member feels it appropriate, the Committee has access, at Company expense, to financial experts of the Committee’s choice who are actively in the business of giving expert advice with respect to the kind of matters that may come before the Committee.

Example of a Questionable Reason for Not Having an ACFE***Crescent Banking Company***

Given our non-urban location, to date we have been unable to identify a suitable candidate for director that would qualify as an “audit committee financial expert,” as defined by the SEC, to become a member of the Audit Committee. The Board of Directors believes that the incumbent Audit Committee members’ financial acumen is strong and that they can discharge the Audit Committee’s responsibilities.

Other Interesting Disclosure of No ACFE (4 other companies mention the ability of the board to hire consultants as needed)***Central Virginia Bankshares Inc.***

CVB has not currently designated an “audit committee financial expert.” The Audit Committee has, however, engaged the accounting firm of Keiter Stephens Hurst Gary & Shreaves to serve as a consultant to the Audit Committee. The Board believes that with Keiter Stephens’ assistance the current members of the Audit Committee have the ability to understand financial statements and generally accepted accounting principles, the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves, an understanding of internal controls and procedures for financial reporting and an understanding of audit committee functions.

(continued on next page)

EXHIBIT 1 (Continued)**Panel B: Disclosures of Companies Who Indicate They Have an ACFE****Most Common Disclosure of an ACFE*****Lincare Holdings Inc.***

The Board of Directors has designated William F. Miller III as the Audit Committee “Financial Expert” as defined by Item 401(h) of Regulation S-K of the Exchange Act and has determined that he is independent within the meaning of Item 7(d)(3)(iv) of Schedule 14A of the Exchange Act.

Cascade Financial Corp.

The current members of the Audit and Finance Committee are “independent” directors within the meaning of both the NASDAQ and Securities and Exchange Commission (SEC) rules. Dr. Murphy is an “audit committee financial expert” as defined under SEC rules.

Examples of Transparent ACFE Disclosure***Marathon Oil Corp.***

Based on the attributes, education, and experience requirements set forth in Section 407 of the Sarbanes-Oxley Act of 2002 and associated regulations, the Board of Directors has determined that David A. Daberko, Charles R. Lee, and Dennis H. Reilley each qualify as an “Audit Committee Financial Expert.”

- Mr. Daberko is currently the Chairman of the Board and Chief Executive Officer of National City Corporation. In addition to certifying the effectiveness of internal controls and procedures required by his position as CEO, Mr. Daberko’s previous positions with National City required him to oversee internal accounting controls and set internal control policy. As head of bank investments, he was responsible for overseeing accounting for that area. Mr. Daberko holds an M.B.A. in finance from Case Western Reserve University.
- Mr. Lee held positions as Senior Vice President-Finance for Penn Central Corp. and Columbia Pictures Industries Inc., and Senior Vice President of Finance with GTE Corporation. He received an M.B.A. with distinction from the Harvard Graduate School of Business Administration.
- Mr. Reilley is the Chairman, President, and Chief Executive Officer of Praxair, Inc. In addition to certifying the effectiveness of internal controls and procedures required by his position as CEO, Mr. Reilley’s experience includes serving as chair of Entergy Corporation’s audit committee. He holds a Bachelor of Science in finance from Oklahoma State University.

Standard Register Company

In addition, the board has determined that one member in particular satisfies the “Audit Committee financial expert” qualifications contained in regulations issued pursuant to the Sarbanes-Oxley Act of 2002. Specifically, the board has concluded that Audit Committee member Sherrill W. Hudson qualifies as an Audit Committee financial expert given his 37-year career as a public accountant and auditor. Mr. Hudson’s experience with respect to audits of financial statements of publicly held companies, internal controls, application [of] GAAP and audit committee functions, and his independence as a board member meets the criteria for “Audit Committee financial expert” established by the board in conformity with the regulations and New York Stock Exchange Listing Standards. The Board has also affirmed that Mr. Hudson’s service on the audit committees of three other publicly traded companies does not impair his ability to serve on the Company’s audit committee, and, in fact, is viewed as an advantage.

auditing, analyzing, or evaluating financial statements, or directly supervising those who perform these functions.

Some of the reasons given for not having a financial expert are novel, whereas others are of questionable veracity. For example, one company reports they do not have an ACFE but that they retain the services of an accounting firm to serve as a consultant to the audit committee. This company argues that its audit committee, with assistance from the accounting firm, has the same skill sets as an ACFE. Another company claims to be unable

to attract a financial expert because of its non-urban location. The company is located approximately 70 miles north of Atlanta, hardly a geographic area that suffers from a paucity of financial experts.

Given the number of companies that disclose that they do not have an ACFE, we take a closer look at exactly what the audit committees of these 25 companies look like. Some audit committee members have unexpected backgrounds. For example, a couple of financial institutions in our sample have a farmer sitting on their audit committee. In fact, one of these companies has an audit committee that includes a farmer, an executive assistant, a veterinarian, a property appraiser, an attorney, and the president of a company. However, based on biographical sketches, each of the companies in our sample that does not disclose an ACFE actually has an audit committee member who may meet the SEC's criteria for ACFE designation. In other words, all of these companies have at least one member on their audit committee who is in a senior management position (i.e., CEO or president). This suggests that companies are cautious in applying the more liberal definition of financial expertise and do not automatically claim an ACFE even though they have members with senior management experience.

Panel B of Exhibit 1 presents examples of disclosures by companies indicating that they have an ACFE. The most common disclosure is to simply state the financial expert's name, indicate that (s)he is independent, and state that the individual qualifies as an ACFE per the SEC's rules. Exhibit 1 also contains examples of disclosures that go beyond the boilerplate that characterizes most companies' disclosures. In our view, transparent disclosures provide the reasons why an individual qualifies to be designated as an ACFE. Since the level of expertise among ACFEs is likely to vary, this additional disclosure allows financial statement users to determine how much comfort they can gain from the presence of a particular individual on the audit committee.

Per Figure 2, only 5 percent of sample companies provide a substantive discussion of the qualifications of the ACFE. While the basis for a director being designated as an ACFE is somewhat apparent if that director has either an accounting or finance background, the basis for directors without such experience is not nearly as obvious. Absent a substantive discussion by the company to explain the justification for their ACFE designation, ascertaining qualifications of CEOs and other officers from their biographical data in the proxy is often impossible. We examined the information in the proxy statement and/or Form 10-K to determine whether the named expert has the requisite background per the SEC's final rule. As documented in Figure 2 (see No Support for ACFE Designation¹⁰), we were unable to do so in more than 40 percent (157/368) of the cases where a company claims to have a financial expert.¹¹ Our inability to independently verify the designated member's expertise is disconcerting. Moreover, the problem is most acute for the very largest companies—we are unable to verify a named expert's qualifications for 54 percent of *Fortune* companies compared to between 33 percent and 42 percent of the companies in the other three

¹⁰ We consider the ACFE designation to be supported if the director has previous experience in accounting or finance, or if there is a significant discussion as to how the director's other experiences result in his/her financial expertise.

¹¹ In addition to the company's ACFE disclosure, we also read the biographical sketch of the named expert included in the company's proxy statement. One limitation of our approach is that companies are only required to disclose the employment history of their directors for the past five years. However, companies can and often do provide more details on a director's employment history.

groups.^{12,13} This result likely reflects the bias of very large companies to populate their boards, and the resulting board committees, with CEOs of other companies, regardless of an individual's background in finance or accounting.

BACKGROUND OF ACFEs

Figure 3 provides descriptive information on the 582 financial experts identified by the 400 companies in our sample. Approximately 40 percent of financial experts serve as the audit committee chair, and the audit committee chair is more likely to be a financial expert for smaller companies.^{14,15} Only 19 percent of the identified financial experts are CPAs, and CPAs are much less likely to serve on the audit committees of larger companies. For example, only 10 (16) percent of the ACFEs of *Fortune* (NYSE) companies are CPAs, whereas approximately 30 percent of Nasdaq companies have a CPA as their financial expert.¹⁶ The minimal presence of CPAs on the audit committees of large companies is surprising, particularly given the importance the SEC attached to accounting expertise in the commentary surrounding the final rule. Furthermore, prior research provides some evidence that the stock market favors ACFEs with an accounting background (DeFond et al. 2005).¹⁷

Figure 3 also shows that approximately 22 percent of the designated financial experts have been added to the audit committee in the past two years. Designated ACFEs for Nasdaq companies are more likely to have joined the board in 2003 or 2004 than are the designated ACFEs for *Fortune* companies ($p < 0.01$ for NMS companies, $p < 0.05$ for NDQ companies). Some of this increase is likely in response to the SEC rule; Table 1 shows that 81 companies added their only designated ACFE during this time period.

Table 3 provides data on the current and prior work experiences of individuals designated as an ACFE.¹⁸ Panel A shows that in terms of current full-time employment, the clear modal background of an ACFE is top management (defined as CEO, President, COO, or chairman of the board). Although this background is more common for experts with *Fortune* and NYSE companies than it is among NDQ companies ($p < 0.05$ for *Fortune* companies

¹² These pairwise differences are significant as follows: $p < 0.05$ when comparing *Fortune* companies to either NYSE or NDQ companies, and $p < 0.01$ when comparing *Fortune* companies to NMS companies.

¹³ In addition, approximately 58 percent of the individual directors named as ACFEs cannot be independently verified, including 74 percent of the financial experts for *Fortune* companies. A greater percentage of financial experts cannot be independently verified for *Fortune* companies compared to NYSE, NMS, and NDQ companies ($p < 0.01$).

¹⁴ Given that some audit committees have more than one financial expert, the percentage of companies in our sample that have an ACFE serving as the chair of their audit committee is higher, at almost 60 percent (236/400).

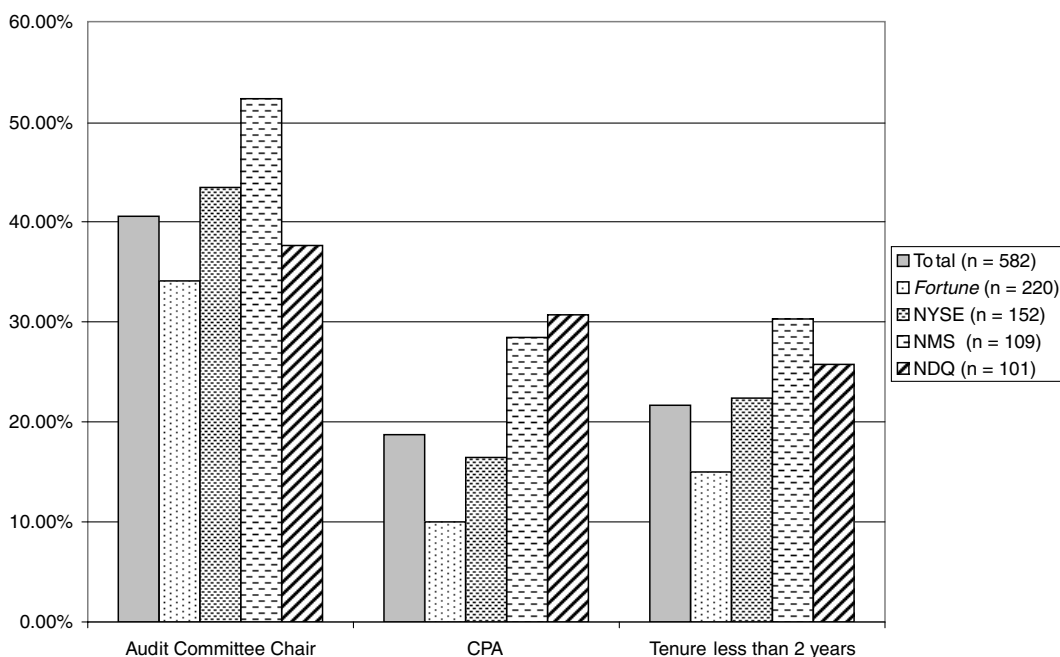
¹⁵ NMS companies are more likely to have an audit committee chair who is a financial expert than are *Fortune* companies ($p < 0.01$) and NDQ companies ($p < 0.05$); NYSE companies are more likely to have an audit committee chair who is a financial expert than are *Fortune* companies ($p < 0.10$).

¹⁶ These pairwise differences are significant as follows: $p < 0.10$ when comparing *Fortune* companies to NYSE companies, $p < 0.01$ when comparing *Fortune* companies to NMS and NDQ companies, $p < 0.05$ when comparing NYSE companies to NMS companies, and $p < 0.01$ when comparing NYSE companies to NDQ companies.

¹⁷ DeFond et al. (2005) find a significant positive stock price reaction when a financial expert with an accounting background is added to the audit committee, but they fail to find any significant stock price reaction when a nonaccounting financial expert is added to the audit committee. However, Davidson et al. (2004) find a significant positive stock price reaction to the appointment of a financial expert to the audit committee, even using different definitions of financial expertise.

¹⁸ In evaluating the current employment of an ACFE (Panel A), individuals are placed into only one category. For example, if an individual serves as CFO and treasurer, which is included in the other financial category, they would be categorized as CFO. Conversely, when evaluating previous employment (Panel B), which often encompasses multiple previous full-time positions, we categorize individuals into as many categories as apply (i.e., the percentages do not sum to 100 percent).

FIGURE 3
Descriptive Statistics for Individual Audit Committee Financial Experts^a



^a Variable Definitions:

Audit Committee Chair = the percentage of financial experts who are also the chair of the audit committee;

CPA = the percentage of financial experts who are also certified public accountants; and

Tenure less than 2 years = the percentage of financial experts who have tenures on the board of less than two years.

and $p < 0.10$ for NYSE companies), it is the most common background for all four groups. Retired individuals are the group next most likely to serve as a financial expert. Financial experts who are retired are more likely to serve on the audit committees of *Fortune* companies than of NYSE, NMS, and NDQ companies ($p < 0.01$).

As expected, the percentage of financial experts with a background in finance and accounting is low. Only 6 percent of financial experts are a sitting CFO and only 5 percent are currently employed as an auditor in public accounting, although almost 16 percent of NDQ companies have a financial expert who is currently employed in public accounting. Even if we define an accounting/finance background broadly (i.e., CFO, VP-Finance, auditor, investment banker, venture capitalist, brokerage/mutual fund experience, treasurer, controller, etc.), only approximately 16 percent of the financial experts have such a background. However, per Panel B of Table 3, when considering *both* current and prior job experience, 21 percent of financial experts have served as a CFO, and 12 percent have experience working as an auditor in a public accounting firm. However, experience as a senior executive still dominates accounting/finance backgrounds even when prior positions are considered.

Our results are consistent with those reported by DeFond et al. (2005) and demonstrate that many ACFEs do not have a background in accounting or finance. However, a key

TABLE 3
Audit Committee Financial Experts
Current and Prior Work Experience

	Total (n = 582)		Fortune (n = 220)		NYSE (n = 152)		NMS (n = 109)		NDQ (n = 101)		Test of Differences					
											Fortune	Fortune	Fortune	NYSE	NYSE	NMS
	No.	%	No.	%	No.	%	No.	%	No.	%	versus NYSE	versus NMS	versus NDQ	versus NMS	versus NDQ	versus NDQ
Panel A: Current Employment of All Audit Committee Financial Experts^a																
Top Management ^c	220	37.80	93	42.27	61	40.13	36	33.03	30	29.70			**		*	
Retired	125	21.48	72	32.73	26	17.11	20	18.35	7	6.93	***	***	***		**	**
CFO	36	6.19	10	4.55	12	7.89	6	5.50	8	7.92						
Auditor ^d	29	4.98	3	1.36	3	1.97	7	6.42	16	15.84		***	***	*	***	**
Other Financial ^e	27	4.64	6	2.73	12	7.89	4	3.67	5	4.95	**					
Financial ^f	92	15.81	19	8.64	27	17.75	17	15.59	29	28.71	***	*	***		**	**
Panel B: Current and Previous Employment of all Audit Committee Financial Experts^b																
Top Management ^c	402	69.07	188	85.45	104	68.42	63	57.80	47	46.53	***	***	***	*	***	
Retired	125	21.48	72	32.73	26	17.11	20	18.35	7	6.93	***	***	***		**	**
CFO	120	20.62	24	10.91	40	26.32	36	33.03	20	19.80	***	***	**			**
Auditor ^d	70	12.03	13	5.91	16	10.53	19	17.43	22	21.78		***	***		**	
Other Financial ^e	81	13.92	15	6.82	27	17.76	16	14.68	23	22.77	***	**	***			
Financial ^f	220	37.80	48	21.82	63	41.45	58	53.21	51	50.50	***	***	***	*		

*, **, *** Indicate significance at $p < 0.10$, $p < 0.05$, and $p < 0.01$, respectively, based on two-tailed tests.

^a Current work experience is coded based on one job title, the highest position currently held. Several individuals hold multiple positions such as CFO and Treasurer. These individuals are coded as CFO.

^b Current and previous work experience is coded based on all positions currently or previously held. Thus, one individual may appear in multiple rows in Panel B, which results in the sum of the CEO, Auditor, and Other Financial categories exceeding the numbers of members with a Financial background.

^c Individuals who hold the position of Chairman, CEO, President, or Chief Operating Officer.

^d Individuals who have experience as an accountant in a public accounting firm.

^e Individuals who hold the position of VP-Finance, venture capitalist, investment banker, brokerage/mutual fund experience, treasurer, controller, etc.

^f Individuals who hold any position included in the CFO, auditor, or other financial categories.

difference between our results and those reported by DeFond et al. is that we use company designations to identify the audit committee members who should be considered an ACFE. Most prior researchers, including DeFond et al., identify ACFEs based on the biographical data included in the proxy statement. As discussed in the previous section, many companies do not supply sufficient information to accurately identify which directors are ACFEs. To demonstrate the significance of the difference in how ACFEs are identified, we compare the ACFEs identified in our sample to the ACFEs who would have been identified using the DeFond et al. approach. This is done by reviewing the biographical data in each proxy statement and coding ACFEs based on that data while ignoring the companies' ACFE designations.

Results (not tabulated) document a substantial difference in the number and types of financial experts identified. Specifically, 86 directors are designated by their company as an ACFE, but they would not be identified as such using the DeFond et al. approach¹⁹ and proxy statement data. In addition, of the 940 audit committee members in our sample who are *not* designated by their company as an ACFE, more than 50 percent would have been classified as an ACFE using the DeFond et al. approach. In many cases, companies do not designate a CEO or president as an ACFE, possibly because the board believes that the individual audit committee member lacks financial expertise, or in order to limit the director's legal liability. The undesignated audit committee members who qualify under the DeFond et al. approach come from 288 companies. Of these, 256 companies designated at least one ACFE; their failure to designate additional qualified audit committee members as ACFEs likely reflects conservatism on the part of the board rather than errors in identifying ACFEs. Conversely, for the 32 companies that do not designate an ACFE (25 companies state that they do not have an ACFE, and seven companies make no disclosure), the failure to designate an audit committee member as an ACFE who meets the DeFond et al. definition of expertise reflects either (1) that the audit committee member identified using the DeFond et al. approach does not really possess financial expertise, or (2) extreme unwillingness on the part of the company to designate an ACFE.

These analyses indicate that assessments of financial expertise on audit committees are likely to be understated, no matter how expertise is assessed. If expertise is measured per the extant literature (e.g., DeFond et al. 2005), then individuals with financial expertise that is not transparent from reading the proxy statement will not be identified. In addition, if expertise is measured based on firm designations, then individuals with financial expertise may not be identified because companies only have to designate one expert. The latter problem appears more acute than the former.

WHY COMPANIES HAVE/DISCLOSE ACFEs

We expect the SEC's financial expert disclosure requirement to pressure companies to designate at least one director who has financial expertise on their audit committee. However, as noted previously, 32 companies in our sample do not disclose an ACFE (25 state they do not have an ACFE and seven make no disclosure at all regarding financial expertise on its audit committee). We examine whether certain company characteristics, largely drawn from the literature on agency costs and corporate governance, explain whether a company discloses the presence of a financial expert on their audit committee. Companies facing greater agency costs should be more likely to have a financial expert on their audit committee than those companies facing lower agency costs. The relation between corporate

¹⁹ DeFond et al. (2005) define an ACFE as an individual who possesses accounting expertise (similar to our definition) or as an individual who holds the position of CEO or president.

governance variables and whether a financial expert is present on the audit committee is less obvious. A better-governed firm may seek to further strengthen its governance through the inclusion of a financial expert, suggesting a positive relation between corporate governance quality and the presence of an ACFE (DeFond et al. 2005). Conversely, some firms may view corporate governance quality as a substitute for audit committee financial expertise, suggesting a negative relation between corporate governance quality and the presence of an ACFE (Engel 2005).

We test the relation between company characteristics and whether a company designates one or more ACFEs using the following logistic regression model:

$$\begin{aligned} ACFE = & b_0 + b_1SIZE + b_2CS_ISSUANCE + b_3DEBT_ISSUANCE + b_4BIG4 \\ & + b_5LITIGATION + b_6CEO_DUALITY + b_7INST_OWN \\ & + b_8BLOCKHOLDER + b_9AC_DILIGENCE + b_{10}NMS + b_{11}NYSE + \varepsilon \end{aligned}$$

where:

ACFE = 1 if the company designates an ACFE, else 0;

SIZE = the natural log of market value of equity;

CS_ISSUANCE = 1 if the company has proceeds from the issuance of common stock greater than 5 percent of stockholders' equity, else 0;

DEBT_ISSUANCE = 1 if the company has proceeds from the issuance of debt, else 0;

BIG4 = 1 if the company engages one of the largest four audit firms, else 0;

LITIGATION = 1 if the company is in a litigious industry, else 0;

CEO_DUALITY = 1 if the chief executive officer is also the chairman of the board, else 0;

*INST_OW*N = percentage of stock held by institutional investors;

BLOCKHOLDER = 1 if the company has a non-insider holder of 5 percent or more of the outstanding shares, else 0;

AC_DILIGENCE = 1 if the audit committee meets four or more times, else 0;

NMS = 1 if the company trades on the Nasdaq National Market System, else 0; and

NYSE = 1 if the company trades on the New York Stock Exchange, else 0.

Larger firms are associated with greater agency costs (Simunic and Stein 1987). In addition, the relative cost of attracting a financial expert to the audit committee should be less for a larger company than a smaller company (Verrecchia 2001). For both reasons, we expect a positive relation between company size and the designation of an ACFE.

Since managers and potential investors have asymmetric information when the firm issues securities, we expect agency costs to be higher when a company issues debt or equity securities. For example, the finance literature finds that stock prices generally decline when a firm announces a new stock issue, and this result is attributed to asymmetries in the information available to managers and investors (Ehrhardt and Brigham 2003). In addition, Dechow et al. (1996) find that fraudulent financial reporting is more likely around securities' issuances. The presence of an ACFE should reduce the risk of fraudulent financial reporting (Abbott et al. 2004); therefore, we expect a positive relation between securities' issuances (*CS_ISSUANCE* and *DEBT_ISSUANCE*) and the designation of an ACFE.

Prior literature finds that fraudulent financial reporting is more likely when the positions of CEO and the chairman of the board (COB) are held by the same individual (Dechow et al. 1996; Beasley et al. 2000). This result suggests that the benefits of having an ACFE are

greater in the case of CEO and COB duality. Conversely, when the CEO and COB positions are held by the same person, this individual often wields significant power, and (s)he may maximize management's financial reporting discretion by not having an ACFE.

Blockholders and institutional investors can play an important role in monitoring managerial behavior (Shleifer and Vishny 1986; Field and Sheehan 2004). As such, an outside blockholder or institutional investor with significant holdings may exert pressure on management to have a financial expert on the audit committee. Conversely, the monitoring benefits offered by an outside blockholder or institutional investor may act as a substitute for the benefits of an ACFE.

Abbott et al. (2004) provide evidence of a negative association between the diligence of the audit committee and restatements. That is, companies whose audit committees meet frequently are less likely to have a subsequent restatement. Companies with a more diligent audit committee may also be interested in having a financial expert on their committee. Conversely, some companies may view audit committee diligence as an acceptable substitute for audit committee financial expertise.²⁰

Abbott and Parker (2000) document a positive association between audit committee effectiveness and the selection of an industry specialist auditor. Although not addressed by Abbott and Parker (2000) as a component of audit committee effectiveness, the presence of an ACFE may also be positively associated with the selection of a high-quality auditor (i.e., a Big 4 audit firm). Conversely, some companies may view the presence of an ACFE and the selection of a Big 4 auditor as substitutes.²¹

Audit committee members face significant risks as a result of their committee service, including the risk of litigation in the event of shortcomings in the financial reporting quality of their company. This litigation-related risk is not equal across industries, and companies that operate in highly litigious industries may place more emphasis on having an ACFE.²² However, concerns over increased legal liability that may result from being named as an ACFE may cause some directors to be even more cautious about being designated as a financial expert. Thus, audit committee members may be less willing to be designated as an ACFE in those industries with increased litigation risk.

Finally, the likelihood of having an audit committee financial expert may differ based on different regulatory regimes and market expectations across different stock exchanges. Thus, we include dummy variables for whether the company is traded on either the NYSE or Nasdaq's National Market System (the effect of NDQ trading on the likelihood of having an ACFE appears in the regression intercept). The *Fortune* companies in the sample are also captured by these indicator variables based on the exchange on which they are listed; thus, unlike the prior tables that separate the sample into four groups, only three exchange-based groups are used in the regression analyses.

²⁰ Abbott et al. (2004) also examine the *independence* of the audit committee. As a sensitivity test, we also include a variable to capture the independence of the audit committee. This variable, whether measured as a dichotomous or continuous variable, is not significant, and the results of our main model are unchanged. The lack of results on our measures of audit committee independence is likely due to the limited variation in audit committee independence for our sample companies.

²¹ The direction of causality between number of audit committee meetings (our proxy for committee diligence) and the designation of an ACFE, and between the presence of a Big 4 firm and an ACFE, may run in the opposite direction. That is, an ACFE may result in more audit committee meetings or in the selection of a Big 4 firm. In this exploratory study, we are simply examining the relation between these variables and the designation of an ACFE.

²² Using the coding scheme in Ashbaugh-Skaife et al. (2005), we define litigious industries as drugs (SIC codes 2833–2836), computers (3570–3577 and 7370), electronics (3600–3674), and retail trade (5200–5961).

In addition to examining the association between company characteristics and the *designation* of an ACFE, we also examine, for those companies that have an ACFE, the association between those characteristics and the *type* of ACFE. Specifically, we examine the characteristics that are associated with companies having an ACFE with an accounting or finance background versus an ACFE with a more general business background. We use the same model as before with the exception that the dependent variable is now *ACCT*, which equals 1 if the company has an ACFE with an accounting or finance background, and 0 otherwise.

Descriptive Statistics

Table 4 presents descriptive statistics for the variables in our regression models. The last column under “Designation of an ACFE” reports the p-values for testing the difference in the means for firms that have versus have not designated an ACFE. The differences are significantly positive for (1) company size, (2) debt issuance, (3) use of a Big 4 auditor, (4) having a CEO who is also chairman of the board, (5) the percentage of stock owned by institutional investors, (6) having an audit committee that meets at least four times per year, and (7) listing on the New York Stock Exchange. Thus, each of these variables is individually positively associated with designating an ACFE. There is also a significant negative difference for companies listed on Nasdaq’s NDQ system.²³ None of the other differences are significant. The columns under “Type of ACFE” show that for those companies that designate an ACFE, their financial expert is more likely to have an accounting or finance background if (1) the company issued common stock, (2) a large outside blockholder exists, or (3) the company is listed on Nasdaq’s NMS. Also, larger companies and companies listed on the New York Stock Exchange are less likely to have an ACFE with an accounting or finance background.

Logistic Regression Results

Designation of an ACFE

Table 5 presents the logistic regression results. The model that examines the designation of an ACFE is significant ($p < 0.01$), and the model’s pseudo- R^2 is 18 percent. As expected, company size is positively associated with the designation of an audit committee financial expert ($p < 0.05$).²⁴ Also, companies that operate in highly litigious industries are also more likely to designate an audit committee financial expert ($p < 0.10$). Finally, companies are more likely to designate a financial expert if their audit committee meets at least four times per year ($p < 0.05$). We do not find an association between the designation of an ACFE and any of the other variables in our model.

²³ We caution against placing too much reliance on the significance of these associations because several of these variables are correlated. Specifically, company size is highly correlated with use of a Big 4 auditor ($\rho = 0.56$), having a CEO who is also chairman of the board ($\rho = 0.35$), the percentage of stock owned by institutional investors ($\rho = 0.61$), and being listed on the NYSE ($\rho = 0.73$). In addition, being listed on the NYSE is highly correlated with use of a Big 4 auditor ($\rho = 0.47$), having a CEO who is also chairman of the board ($\rho = 0.36$), and the percentage of stock owned by institutional investors ($\rho = 0.59$). Finally, issuing debt securities is negatively correlated with issuing equity securities ($\rho = -0.52$), but positively correlated with use of a Big 4 auditor ($\rho = 0.37$). The percentage of stock owned by institutional investors is positively correlated with use of a Big 4 auditor ($\rho = 0.56$). All of the remaining correlations are 0.35 or less.

²⁴ Given the correlations reported in footnote 23, the significant mean differences in Table 4 and insignificant coefficients in Table 5 could be the result of multicollinearity. Unreported regressions using subsets of variables confirm that the explanatory power of Big 4, CEO duality, institutional ownership, and stock exchange listing disappears when size is included in the model.

TABLE 4
Means of Variables that May Explain ACFE Designation and/or Type

Variable ^a	Entire Sample (n = 398) ^b	Designation of an ACFE			Type of ACFE ^d		
		ACFE Firms (n = 366)	No ACFE Firms (n = 32)	(ACFE – No ACFE) ^c	Acct ACFE Firms (n = 200)	Non-Acct ACFE Firms (n = 164)	(Acct – Non-Acct) ^c
<i>SIZE</i>	14,163.650	15,363.350	442.135	0.0171	9,766.623	22,330.570	0.0026
<i>CS_ISSUANCE</i>	0.415	0.407	0.500	0.3064	0.445	0.366	0.0633
<i>DEBT_ISSUANCE</i>	0.839	0.847	0.750	0.0761	0.855	0.835	0.3028
<i>BIG4</i>	0.804	0.825	0.563	0.0003	0.800	0.860	0.1338
<i>LITIGATION</i>	0.206	0.216	0.094	0.1015	0.220	0.207	0.7692
<i>CEO_DUALITY</i>	0.636	0.653	0.438	0.0151	0.635	0.671	0.4767
<i>INST_OWN</i>	0.480	0.499	0.259	0.0000	0.514	0.481	0.3153
<i>BLOCKHOLDER</i>	0.709	0.708	0.719	0.8946	0.750	0.652	0.0421
<i>AC_DILIGENCE</i>	0.950	0.964	0.781	0.0000	0.975	0.951	0.2238
<i>NMS</i> ^e	0.261	0.254	0.344	0.2683	0.300	0.195	0.0220
<i>NYSE</i> ^e	0.490	0.519	0.156	0.0001	0.480	0.573	0.0766
<i>NDQ</i> ^e	0.249	0.227	0.500	0.0006	0.220	0.232	0.7902

^a Variable Definitions:

SIZE = firm's price per share at fiscal year-end (Compustat #199) multiplied by the number of shares outstanding (Compustat #25), in millions;

CS_ISSUANCE = 1 if the company has proceeds from the issuance of common stock (Compustat #108) greater than 5 percent of stockholders' equity (Compustat #216), else 0;

DEBT_ISSUANCE = 1 if the company has proceeds from the issuance of debt; else 0 (Compustat #111);

BIG4 = 1 if the firm engages one of the largest four audit firms, else 0 (Compustat #149);

LITIGATION = 1 if the company is in a litigious industry, else 0. Litigious industries are defined as SIC codes 2833–2836, 3570–3577, 3600–3674, 5200–5961, and 7370 (Compustat #324);

CEO_DUALITY = 1 if the chief executive officer is the chairman of the board, else 0 (Proxy);

INST_OWN = percentage of stock held by institutional investors (Compact D/SEC);

BLOCKHOLDER = 1 if a non-insider holds 5 percent or more of the company's outstanding shares, else 0 (Proxy);

AC_DILIGENCE = 1 if the audit committee meets four or more times, else 0 (Proxy);

NMS = 1 if firm is traded on the Nasdaq National Market System, else 0 (Compact D/SEC);

NYSE = 1 if firm is traded on the New York Stock Exchange, else 0 (Compact D/SEC);

NDQ = 1 if firm is traded on the Nasdaq National Dealer Quotation, else 0 (Compact D/SEC).

^b Two of 400 companies in our original sample do not disclose the number of audit committee meetings (*AC_DILIGENCE*). These companies are excluded from our logistic regression models.

^c Values represent p-values from one-tailed tests for differences between groups for variables whose relation to the dependent variable is predicted (*SIZE*, *CS_ISSUANCE*, and *DEBT_ISSUANCE*), and two-tailed tests for all other variables. Test for differences in the means are based on t-statistics (Z-statistics) for continuous variables (proportions).

^d Two of the 366 companies that disclose the existence of an ACFE do not provide the name of the expert. Therefore, for these two companies we cannot categorize the ACFE as an Acct ACFE or as a Non-Acct ACFE.

^e Each exchange variable includes the companies in the *Fortune* subsample that trade on that exchange (96 NYSE, 4 NMS, 0 NDQ).

TABLE 5
Logistic Regressions

Variable ^c	Expected Sign	Designation of an ACFE (ACFE) ^a		Type of ACFE (ACCT) ^b	
		Estimated Coefficient	p-value ^d	Estimated Coefficient	p-value ^d
Intercept		-0.5179	0.598	-0.9664	0.191
SIZE	+	0.3139	0.033	-0.0810	0.226
CS_ISSUANCE	+	0.0537	0.457	0.5203	0.028
DEBT_ISSUANCE	+	-0.0659	0.916	0.6351	0.055
BIG4	?	-0.2688	0.612	-0.8561	0.032
LITIGATION	?	1.3110	0.052	-0.0312	0.913
CEO_DUALITY	?	0.2501	0.548	0.0265	0.915
INST_OWN	?	1.2763	0.216	1.1645	0.037
BLOCKHOLDER	?	-0.6351	0.190	0.1296	0.625
AC_DILIGENCE	?	1.3664	0.024	0.8746	0.167
NMS	?	-0.3634	0.506	0.5372	0.171
NYSE	?	-0.0708	0.939	0.0623	0.898
Number of Observations		398		364	
Chi-Square for Model		39.62		23.23	
(degrees of freedom)		11		11	
p-value		0.0000		0.0164	
Pseudo R ²		0.18		0.05	

^a This analysis examines all sample companies with the requisite data. The dependent variable for this analysis is coded 1 if the company discloses having an ACFE, else 0.

^b This analysis examines all companies that disclose having at least one ACFE. The dependent variable for this analysis is coded 1 if the company discloses having at least one ACFE with an accounting background, else 0.

^c See Table 4 for variable definitions.

^d Values represent p-values from one-tailed (two-tailed) tests for variables whose relation to the dependent variable is (is not) predicted.

Type of ACFE

The logistic regression model that examines whether the ACFE has an accounting or finance background is significant ($p < 0.01$) and the model's pseudo- R^2 is 5 percent. As expected, having an ACFE with an accounting or finance background is significantly associated with *DEBT_ISSUANCE* ($p < 0.10$) and *CS_ISSUANCE* ($p < 0.05$). This suggests that companies are more likely to designate an ACFE who has an accounting or finance background if they are going to the capital markets to raise funds. The percentage of stock owned by institutional investors is also significantly positively associated with the presence of an ACFE with an accounting or finance background ($p < 0.05$). This is consistent with institutional shareholders putting pressure on the company to have a qualified audit committee financial expert. However, the significant negative association between having an accounting ACFE and the use of a Big 4 audit firm ($p < 0.05$) seems to suggest that the selection of a Big 4 auditor acts as a substitute for designating an accounting ACFE.

SUMMARY, LIMITATIONS, AND FUTURE RESEARCH

The Sarbanes-Oxley Act requires all public companies to disclose whether a financial expert sits on the audit committee. We examine the initial disclosures made under the SEC's financial expert disclosure rule by a broad cross-section of public companies. Although almost every company in our sample complies with the new rule, the quality of their disclosure is often lacking and is limited to a minimal, typically boilerplate, explanation of why an individual director is designated as an ACFE. Also, a nontrivial number of companies disclose that they do not have an ACFE while others designate multiple ACFEs. Consistent with prior research, we also find that the typical ACFE lacks recent, direct experience in accounting or finance; this finding is particularly pronounced for larger companies. However, unlike prior research that had to classify directors as financial experts based on biographical data in the proxy statement, we rely on classifications made by the companies in their disclosures. Our results highlight substantial differences in the classification of financial experts using these alternative approaches, including the apparent reluctance of some companies to name seemingly qualified directors as ACFEs, possibly due to concerns about the legal liability faced by designated ACFEs. Finally, we identify certain company characteristics that are associated with the designation or type of financial expert on the audit committee.

This study is subject to a number of limitations. First, although we attempt to examine disclosure behavior among very large companies and a random sample of other exchange-traded companies, our sample could be nonrepresentative of the underlying populations from which it is drawn. Second, we are dependent on companies' public disclosures in their 10-Ks and proxy statements for our analyses.

Given the newness of the SEC's financial expert disclosure rule, a number of opportunities exist for future research. Among the questions that researchers might examine include:

- Why do some companies choose to designate more than one financial expert on their audit committee?
- Why are some companies reluctant to designate seemingly qualified directors as ACFEs while other companies designate multiple ACFEs?
- Do companies prone to more extensive earnings management experience a larger positive stock price reaction upon the appointment of an ACFE than companies less prone to earnings management?

REFERENCES

- Abbott, L. J., and S. Parker. 2000. Auditor selection and audit committee characteristics. *Auditing: A Journal of Practice & Theory* (Fall): 47–66.
- , ———, and G. F. Peters. 2004. Audit committee characteristics and restatements. *Auditing: A Journal of Practice & Theory* (March): 69–87.
- Agrawal, A., and S. Chadha. 2005. Corporate governance and accounting scandals. *Journal of Law and Economics* (October): 371–406.
- Anderson, R. C., S. A. Mansi, and D. M. Reeb. 2004. Board characteristics, accounting report integrity, and the cost of debt. *Journal of Accounting and Economics* (September): 315–342.
- Ashbaugh-Skaife, H., D. Collins, and W. Kinney. 2005. The discovery and consequences of internal control deficiencies prior to SOX-mandated audits. Working paper, University of Wisconsin–Madison, The University of Iowa, and The University of Texas at Austin.

- Beasley, M. S., J. V. Carcello, D. R. Hermanson, and P. D. Lapedes. 2000. Fraudulent financial reporting: Consideration of industry traits and corporate governance mechanisms. *Accounting Horizons* (December): 441–454.
- Bédard, J., S. M. Chtourou, and L. Courteau. 2004. The effect of audit committee expertise, independence, and activity on aggressive earnings management. *Auditing: A Journal of Practice & Theory* (September): 13–35.
- Bostelman, J. T. 2004. *The Sarbanes-Oxley Deskbook*. New York, NY: Practicing Law Institute.
- Colvin, G. 2002. Sarbanes & Co. can't want this: Under the reform law, Alan Greenspan would not qualify as a board's financial expert. *Fortune* (December 30).
- Davidson, W. N. III, B. Xie, and W. Xu. 2004. Market reaction to voluntary announcements of audit committee appointments: The effect of financial expertise. *Journal of Accounting and Public Policy* (July/August): 279–293.
- Dechow, P. M., R. G. Sloan, and A. P. Sweeney. 1996. Causes and consequences of earnings manipulation: An analysis of firms subject to enforcement actions by the SEC. *Contemporary Accounting Research* (Spring): 1–36.
- DeFond, M. L., and J. R. Francis. 2005. Audit research after Sarbanes-Oxley. *Auditing: A Journal of Practice & Theory* (Supplement): 5–30.
- , R. N. Hann, and X. Hu. 2005. Does the market value financial expertise on audit committees of boards of directors? *Journal of Accounting Research* (May): 153–193.
- Engel, E. 2005. Discussion of: Does the market value financial expertise on audit committees of boards of directors? *Journal of Accounting Research* (May): 195–204.
- Ehrhardt, M. C., and E. F. Brigham. 2003. *Corporate Finance: A Focused Approach*. Mason, OH: Thomson South-Western.
- Field, L. C., and D. P. Sheehan. 2004. IPO underpricing and outside blockholdings. *Journal of Corporate Finance* (March): 263–280.
- Healy, P. M., and K. G. Palepu. 2001. Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical disclosure literature. *Journal of Accounting and Economics* (September): 405–440.
- Scannell, K. 2004. Judge decides some directors are more liable. *Wall Street Journal* (October 12): C1.
- Securities and Exchange Commission (SEC). 2002a. *Proposed Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date*. June 17. Washington, D.C.: Government Printing Office.
- . 2002b. *Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002*. October 22. Washington, D.C.: Government Printing Office.
- . 2003. *Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002*. Washington, D.C.: Government Printing Office.
- Shleifer, A., and R. W. Vishny. 1986. Large shareholders and corporate control. *Journal of Political Economy* (June): 461–489.
- Simunic, D. A., and M. T. Stein. 1987. *Product Differentiation in Auditing: Auditor Choice in the Market for Unseasoned New Issues*. Vancouver, B.C.: Certified General Accountants' Research Foundation.
- U.S. House of Representatives. 2002. The Sarbanes-Oxley Act of 2002. Public Law 107-204 [H. R. 3763]. Washington, D.C.: Government Printing Office.
- Verrecchia, R. E. 2001. Essays on disclosure. *Journal of Accounting and Economics* (December): 97–180.